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BRIDGING THE SMALL BUSINESS CAPITAL GAP: PEER-TO-PEER LENDING

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTEENTH CONGRESS

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BRIDGING THE SMALL BUSINESS CAPITAL GAP: PEER-TO-PEER LENDING

WEDNESDAY, MAY 13, 2015

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 11:00 a.m., in Room 2360, Rayburn House Office Building. Hon. Steve Chabot [chairman of the Committee] presiding.

Present: Representatives Chabot, Luetkemeyer, Hanna, Huelskamp, Gibson, Hardy, Velázquez, Clarke, Payne, and Adams.

Chairman CHABOT. Good morning. The Committee will come to order, and I want to thank everyone for being here today.

When an entrepreneur starts a business, one of the first challenges faced is getting the money needed to produce their new product or patent a new idea. Often, an entrepreneur will reach out to friends and family for early support, and sometimes a small monetary investment.

This common phenomenon of family and friends' investment is far more common than is commonly realized. After all, we all want to see our friends and family succeed, particularly in a new business venture.

While access to capital has always been a concern for small firms, the Great Recession and some legislation, some would argue, I would, Dodd-Frank, for example, have made access to capital even more difficult.

Fortunately, there are alternative lending options to assist small businesses in getting the financing they so desperately need. Today's hearing will examine a growing trend across America, the rise of peer-to-peer or P2P lending, and what it means for small businesses.

A recent survey by the New York Federal Reserve found that while small businesses primarily still look to large conventional lenders for financing, during the first half of 2014 nearly 20 percent of entrepreneurs looked to an online lender for credit. In the United States, the P2P lender with the largest market share, Lending Club, has seen the value of its total loans funded for small businesses explode from around $850,000 in 2007 to over $22 million in 2012.

This increase in P2P lending for small businesses, if it continues, could have a tremendously positive impact on small businesses and their growth and on the American economy overall.

Today, we are fortunate to be joined by a distinguished group of witnesses who all have insight into this fast growing phenomenon.

I want to thank our panel for taking time away from their jobs and making the trip to Washington for this important hearing. We look forward to your testimony.

It is often said that what keeps a great idea from becoming a great business is execution. Well, access to the funds needed to start a business plays a huge role in that success. There are people all around our country with great ideas. Hopefully today, we can examine how innovative funding models can help more Americans turn their great ideas into a reality.

I would now like to yield to the Ranking Member, Ms. Velázquez, for her opening remarks.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman. Following the 2008 financial crisis, the small business credit market tightened dramatically, contracting at twice the rate of broader financial markets.

After banks pulled back $116 billion in capital, many entrepreneurs were forced to turn to non-traditional sources to stay afloat. One alternative to emerge was peer-to-peer lending. Peer-to-peer lending allows small businesses to directly solicit funding from a pool of interested lenders and investors over the Internet. Web-based technologies reduce costs and interest rates making peer-to-peer business loans an attractive alternative to credit cards.

Peer-to-peer offers a number of benefits to both small businesses and investors. For small business borrowers, the biggest advantage is being able to access capital when traditional lenders are not willing to make loans. P2P platforms also provide loans that are often too small to be profitable for most banks, typically under $35,000.

On the investor side, the communal and open nature of P2P lending reduces fraud while technology based risk assessment helps inform investors about each individual loan.

Although peer-to-peer lending provides significant advantages, there are drawbacks. Peer-to-peer lending platforms reserve the right to reject small business applications just like banks. The Federal Reserve found only eight percent of business loan applications are accepted by the largest platform. The study also found that peer-to-peer loans had an average interest rate of over 13 percent, double that of traditional sources. Similarly, peer-to-peer loans have higher default rates, increasing investor risks.

As more people learned of the advantages of peer-to-peer lending, the industry grew rapidly through the mid-2000s. In 2008, the SEC took notice in citing investor protection and classified peer-to-peer lending loans as securities. This move subjected lending platforms to a host of registration requirements.

As a result, many industry participants have raised concerns that the current environment is limiting the market's growth potential. Very few platforms have taken the costly steps of registering with the SEC, preventing many retail investors from participating in peer-to-peer lending.

At the same time, large institutional investors have been attracted to peer-to-peer lending by high yield, less oversight, and lower costs.

While increasing access to capital is a laudable goal, the peer-to-peer market is now dominated by the same institutions it was

meant to circumvent, raising concerns about the direction of this nascent industry.

Today's hearing will provide members an opportunity to learn about the peer-to-peer lending market and how it has facilitated small business' access to capital. With more firms turning to Internet based lenders, including crowdfunding sites, and peer-to-peer lending, it is important the committee examine how we can ensure these platforms increase small business access to capital while protecting both, borrowers and investors.

I just want to take this opportunity to thank all the witnesses for being here today.

Chairman CHABOT. Thank you very much. We ask that Committee members, if they have opening statements, submit them for the record.

I would like to take just a moment to explain our lighting system here. You will each be given five minutes to testify. The green light will be on for four minutes, the yellow light will come on to let you know you have a minute to wrap up, and then the red light will come on. We would ask you try to adhere to those five minutes, if at all possible, we will give you a little leeway, but not a lot. We appreciate it.

I would now like to introduce our panel, and I will introduce each of you before you testify. Our first witness is Rajkamal Iyer, who is an Associate Professor of Finance at the MIT Sloan School of Management.

Professor Iyer's research focuses on the area of banking and contract theory, with a particular interest in understanding the role of inter-bank markets and the provision of liquidity. We appreciate you being here and we will get to your testimony in just a minute.

Our next witness is Sam Hodges, who is the Co-Founder and Managing Director of Funding Circle, a peer-to-peer lending platform focused exclusively on small businesses.

Mr. Hodges is responsible for overseeing the overall strategic direction and day-to-day operation of Funding Circle in the U.S., and we welcome you here as well.

Our third witness will be Zachary Green. I am very pleased to introduce Mr. Green because he happens to be from my District. He is the CEO and Founder of MN8 Foxfire in Cincinnati.

Mr. Green previously served in the United States Marines Corps and was working as a volunteer firefighter when he developed the idea for his small business, which as he will tell you in a minute, is meant to keep firefighters safe. We thank you for your service to our country and also for making the trip from the First District to be with us today.

I would now like to yield to the Ranking Member, Ms. Velázquez, for introducing her witness.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman. It is my pleasure to introduce Mr. Peter Renton. He is the Founder of Lend Academy, the leading educational resource for the peer-to-peer lending industry.

His blog is the most widely read website about peer-to-peer lending, and through his writing and video courses, he has helped tens of thousands of people understand this new asset class. He is con-

sidered the world's leading expert on peer-to-lending and often consults with companies looking to enter the space.

He is also Co-Founder of the LendIt Conference, the world's first conference dedicated to the peer-to-peer lending online lending industry, and he is the author of "The Lending Club Story," the definitive guide to the world's largest peer-to-peer lender.

Thank you and welcome.

Chairman CHABOT. Thank you very much. Professor Iyer, you are recognized for five minutes.

STATEMENTS OF RAJKAMAL IYER, ASSOCIATE PROFESSOR OF FINANCE, MIT SLOAN SCHOOL OF MANAGEMENT; SAM HODGES, CO-FOUNDER AND MANAGING DIRECTOR, FUNDING CIRCLE; ZACHARY L. GREEN, CEO/FOUNDER, MN8 FOXFIRE; PETER RENTON, PUBLISHER, LEND ACADEMY

STATEMENT OF RAJKAMAL IYER

Mr. IYER. Thank you for giving me the opportunity to be here this morning. As you have read, I was interested in banking and financial intimidation, and that led me naturally to look at peer-to-peer markets when I learned that these new online markets had been put up to provide access to credit for small businesses and individuals.

What was interesting about these markets was that loans were funded by a group of small investors as compared to sophisticated lenders and loan officers and other intermediaries.

One of the big problems in credit markets in general has been screening of investors, in a sense how do you really understand the creditworthiness of people who are borrowing. What was fascinating about these markets is to think about whether small individuals who are lenders can actually screen effectively the borrower's creditworthiness, because at the end of the day, if you cannot figure out the risk of whom you are lending to, then these markets cannot be sustainable and survive in the long run.

What we did with our co-authors at the University of Chicago and Harvard is at that time one of the biggest lenders in this market was Prosper, so we got data from Prosper, all the loan applications, and the loans which were funded by this website.

In this website what you have is individual lenders can basically decide whether they want to fund a loan and they rely on hard information and they also rely on soft information, which is all the postings which borrowers say about themselves.

What was very interesting was we found these small lenders do remarkably well. In fact, when you look at the default rates, the predictability of default rates for these borrowers, if you look at the credit score, like Experian or something, we found these lenders actually have 45 percent higher predictability than just using the credit score. They do much better in terms of effectively predicting default than just a credit score which banks and many other lenders use.

Having said that, what we basically kind of say is the people who are lending in these markets are not stupid. They are not losing money in general.

What was also interesting is these markets just beyond looking at hard information were using stuff which was non-standard, like they were using soft information to effectively screen borrowers.

What we found was for the low credit score borrowers, these markets were relying much more on soft information to basically judge the effectiveness of lending. In a sense, given that these markets could screen borrowers and also the non-collateralized nature of lending, because these markets do not require collateral, this could be a viable and sustainable source of funding for small borrowers who might be limited to other costly sources of finance to actually meet their requirements.

One could ask what are the risks of these markets. In finance, without risk, there is no return. There is always some risk. What we basically thought in a sense was at this point investors have risks because there is going to be some default, but they can effectively judge the risk. It is not like they are not able to price this risk correctly.

In terms of the platforms, the platforms themselves are not leveraging up. They are just acting like an intermediary which matches lenders to borrowers. At that point, they are not like a bank which basically takes on leverage and lends on its own behalf. In a sense, these platforms are just matching platforms. They bring together lenders and borrowers and the lenders decide what is the rate to lend to, so at some level, that is something that does not pose a big risk at this point to the system.

One could ask are borrowers better off borrowing from these platforms as compared to banks, do they offer better rates. That is a very tricky question because at some level, with all the studies, there is a selection of people who go on these platforms, so the ideal counterfactual would be to look at the same person when he applies for a loan at a lending platform, which is a bank, and see what the rate is.

We do not have that counterfactual at this point because we do not see that clearly. In a sense, at this point from the study we have done, generally the rates on this platform range from six percent to 21 percent, on the average, 14 percent, which is pretty much very similar to the lending rates which banks offer to small borrowers who are at a certain level of credit risk.

Even if the rates offered by these platforms are very similar to banks, they provide an alternative because there is no competition at some level, which is always beneficial for people to basically have another option to lend.

Effectively, at this point, given the nascent nature of this industry, our take is that regulating this industry would inhibit its growth, but having said that, one does need to watch the fact of how these industries evolve, to make sure that is not a constraint.

Thank you.

Chairman CHABOT. Thank you very much. Mr. Hodges, you are recognized for five minutes.

STATEMENT OF SAM HODGES

Mr. HODGES. Mr. Chairman, Ranking Member Velázquez, and members of the Committee, thank you very much for having me here today.

I am Sam Hodges, Co-Founder of Funding Circle, and also a small business owner. Before starting Funding Circle, my partners and I were very much like the hard working entrepreneurs, aspiring small business owners in each of your districts. We built up a chain of fitness centers all across the country, and as we pushed to open new locations, we found even with strong traction, it was very hard to get access to credit.

That experience really aspired us to start Funding Circle as a better way for small businesses to get access to loans. Founded in 2010, Funding Circle is now the world's leading marketplace lender dedicated to small business.

Since then, we have lent out over $1 billion to over 8,000 small businesses across the United States and also the U.K., and we are currently lending out about $75 million per month, ranging from a logistics business in the Midwest to a health care services business in suburban Atlanta, to a multi-unit salad company in San Francisco.

What we are focused on is helping the 28 million small businesses in the United States get access to the capital they need to grow and to expand.

Our loans address the core of the small business credit gap, term loans of $25,000 up to $500,000. These are loans that a small business owner can use to expand her store front, open a new location, hire more staff, or potentially launch new products.

Not only are loans delivered very quickly, inside of a few days, but they are also delivered in a highly transparent fashion. They are also fairly priced with interest rates ranging from about six percent up to 21 percent, with payments spread over an one to five year term.

Today, if you ask the average small business owner whether they have access to the credit they need to grow and expand, I think what you would find is in many cases, the answer is a resounding "no."

Even as our economy recovers and despite attempts such as the JOBS Act to facilitate the flow of capital to smaller companies in the United States, many small businesses remain unable to access the credit they need.

We think that Funding Circle and other marketplace platforms like ours can be a meaningful part of the solution to this problem.

To give you a sense of how this works, we and other marketplace lenders function by matching supply of capital with demand. On the one side of the market are small businesses and on the other are a mix of individuals and institutions who lend through us. We provide a transparent marketplace that is information rich that allows those investors to make good decisions as to where to direct their capital.

This year we anticipate lending over $1 billion through the model. Without access to term capital, what we are seeing is small businesses are actually commonly entering into short term credit arrangements with lenders that often times charge APRs between 50 and 100 percent.

For example, a small business may take a cash advance in exchange for allowing the lender to deduct a portion of credit card sales in what is generally known as a "merchant cash advance."

These are appropriate in some circumstances. For example, funding of working capital, purchasing inventory, for example. Such short term and high rate products can be misused and often times leads small businesses to use these short term financings to actually cover longer term funding needs.

The two attributes, short durations and very high rates, drive many small businesses into downward cycles of re-borrowing, in which they take out more and more debt to roll over their obligations.

We frequently see the damage these arrangements can inflict on small business. Otherwise healthy companies are throttled by overwhelming and unexpected debt service. If this issue sounds familiar, that is because it is.

Regulators, I think, rightfully saw the same connection with payday lending, where very high rates of default and re-borrowing actually led consumers into debt traps.

In response to this trend, Funding Circle is committed to working with other marketplace lenders, other responsible credit providers, and small business advocates to promulgate effective self regulatory standards for non-bank small business financing.

Although we would expect these standards to cover a broad spectrum of practices, transparency around pricing stands out as a particularly important focal point. At Funding Circle, we prominently disclose total and periodic costs of the loans we offer in an easy to understand format, including our interest rate, as well as our fees.

With this information, a small business owner can evaluate the true cost of credit and make a really good informed purchasing decision for that loan.

In contrast, many other lenders quote financing costs as a buy rate and refuse to provide actually an annualized interest rate or any disclosure around fees. In addition, they often times charge hidden fees, and sometimes they will advertise no prepayment penalties despite the fact that if a borrower were to repay all future payments due including interest.

In contrast, the very transparency of the marketplace lending or peer-to-peer model actually helps ensures that only the borrowers who should be able to pay back a loan actually take one out. We believe supporting marketplace lenders represents a critical opportunity for policy makers to help improve small business owners' access to credit, while also giving them a reasonable path to growth.

At Funding Circle, we are striving to build a better financial world. We are trying to craft a transparent market driven approach that delivers much needed capital to great small businesses all across the country. It is our strong believe that marketplace lending will be beneficial for these small businesses, for the investors who are putting capital behind them, and for our country as a whole.

Thank you again for the time and for everything you are doing on behalf of American small business.

Chairman CHABOT. Thank you very much. Mr. Green, you are recognized for five minutes.

STATEMENT OF ZACHARY L. GREEN

Mr. GREEN. Good morning. My name is Zachary Green, and I am the CEO and Founder of MN8 Foxfire. I would like to personally thank Chairman Chabot and the members of the Small Business Committee for inviting me here today.

As a young man growing up in Cincinnati, Ohio, I had three distinct dreams. I wanted to become a Marine, a firefighter, and an entrepreneur. Dedication, honor, team work, and most of all mission accomplishment were some of the life long values I garnered from my time in the Corps.

I recognized that having the opportunity to pursue the American dream is because of those who have gone before us, and we must never forget we are the land of the free only because of the brave.

Several years later and about 50 additional pounds, I fulfilled my second dream of becoming a volunteer firefighter, a rich American tradition started by one of our founding fathers, Benjamin Franklin. Being a firefighter, much like being a Marine, taught me that no obstacle is too large, no hill is too steep, and all challenges can be solved through leadership, team work, and perseverance.

After all, in the fire service we have to solve the problem at hand. We do not have the option of calling 912 after the homeowner calls 911.

The summers in Parrish Island and TwentyNine Palms were unbearable. Marine Corps officer training in Quantico was extremely challenging, as is being a firefighter running into a burning building when everybody is running out.

All these pale in comparison to the challenges I have recently encountered fulfilling my third dream, becoming an entrepreneur. I came up with the idea of MN8 Foxfire while I was sitting on the tailboard of my fire engine. As a firefighter, some of our biggest risks are accountability and disorientation, all of which are compounded exponentially in the dark.

I remember seeing a special about September 11 and how the 911 Commission report noted several times how photoluminescence materials helped people evacuate the Twin Towers before they collapsed. I thought of ways I could apply the same technology to firefighter accessories, and over the next several months I drove from fire station to fire station selling accessories out of the trunk of my car.

Sales steadily increased and my former Fire Chief, Robert Rielage, sat me down and said he believed in me and this product. He said I should not just treat this as a hobby but rather look at a way to really grow a company.

As I walked out of his office, I remembered the words of one of my favorite leaders, Teddy Roosevelt, “At any moment of decision, the best thing you can do is the right thing, the next best thing is the wrong thing, and the worse thing you can do is nothing.”

I refinanced my home, maxed out my credit cards, took nearly all my family savings to efficiently start my journey to entrepreneurship. I am proud to say that now we have more than 60,000 firefighters using our products.

Additionally, we have grown our safety line of products such as ecofriendly exit signs that never need maintenance, batteries or electricity, unlike this one behind me up here on the wall, and we

have a patented product that goes on the edges of stairs to illuminate the stairwells of sports arenas, high rises, universities, all over the U.S. and abroad.

Thanks to the help of the U.S. Department of Commerce's Commercial Services Division, we have also exported this technology to more than 25 countries throughout the world, including the Civil Defense Headquarters of the United Arab Emirates.

In 2013, MN8 Foxfire was awarded the Excellence in Entrepreneurship Award, and I was named Entrepreneur of the Year by the Ohio Chamber of Commerce. I could not have been more proud but every day is a significant struggle.

One of Foxfire's biggest challenges, one many business owners share, is the access to working capital. I love my mother very much, but the words of one of my mentors could not ring more true, cash is more important than your mother.

I always thought the more Foxfire grew and the more we sold, the less I would have to worry about capital. I could not have been more wrong. When I realized that my personal investments would not be enough to finance our rapid growth, I raised capital from friends and family. With that capital, I hired more staff, I bought more inventory, but it still was not enough to keep up with our supply chain and overhead costs.

I next worked with a local venture capital advisory firm and raised additional equity funds, and those funds coupled with lines of credit from our regional lender, the Bank of Kentucky, allowed us to continue to grow.

Almost every entrepreneur I know has the same reoccurring nightmare, running out of money. Several months ago due to several unforeseen circumstances, this almost happened. We were fortunate to find a new stream of revenue through StreetShares, a peer-to-peer lender described by the press as "Shark Tank meets eBay."

We presented our business case with historical financials, tax returns, and a pitch describing how we would use the new funds. StreetShares is a peer-to-peer Internet based marketplace that matches borrowers and lenders by shared social affinity, such in this case, veterans lending to veterans, to drive down rates and the risk of going through a reverse auction model.

Under 36 hours, Foxfire received the money we needed, and the interest rate was in the teens. If we had gone through the same process with traditional financial institutions, it could have taken months. If we had gone to one of the small business payday type lenders, they could have charged us an outrageous APR.

The StreetShares' loan had a reasonable APR but was just as fast. If it was not for the quick access to an online peer-to-peer loan, I fear the worse could have happened to Foxfire.

This is a perfect example of how the free market can act faster than a larger traditional institution and keep that American dream alive.

I became an U.S. Marine, I became a firefighter, and thanks to new ways to fund start-ups like peer-to-peer micro loans, I am on my way to becoming a successful entrepreneur.

Thank you again for your time today.

Chairman CHABOT. Thank you very much, I appreciate it. Having spent last Sunday with my wife of 41 years and my mom who is 90 and my mother-in-law who is 95, I am not going to tell them what you just said.

Mr. GREEN. I did not let my mom proofread this.

Chairman CHABOT. Good. We do remember it. Thank you. Mr. Renton, you are recognized for five minutes.

STATEMENT OF PETER RENTON

Mr. RENTON. Thank you. Mr. Chairman, Ranking Member Velázquez, members of the Committee, I really appreciate you inviting me here today.

My name is Peter Renton, and I help run three businesses that are all focused on the peer-to-peer lending industry. I am the Founder and CEO of Lend Academy, which operates the leading peer-to-peer lending blog, podcast, and community forum. I am also the Co-Founder and CEO of the LendIt Conference, which is the first and largest conference series dedicated to the broader online lending community.

I am also a Co-Founder of NSR Invest, which is an investment and analytics platform that provides access to peer-to-peer marketplaces for financial advisors, institutional investors, and individuals.

As you can tell, I am not from this country. I grew up in Sydney, Australia, where my father was an entrepreneur, and I joined the family printing business one year after graduating college.

Like most entrepreneurs in Australia, I dreamed of one day starting a business in this country, and I was able to do that in 1991 when I moved to Denver, Colorado to expand our family printing business. Since then, I have started several other businesses, and in 2003, I proudly became a United States citizen.

I have been investing in peer-to-peer lending platforms, now often referred to as "marketplace lending platforms," since 2009. I have been covering this industry full time as a blogger and analyst since 2010.

What I would like to do in this testimony is give you a little history and overview of the peer-to-peer lending industry, particularly as it pertains to small business.

In this country, peer-to-peer lending began in 2006 with the launch of Prosper. Industry leader Lending Club followed just a year later. The SEC decided in 2008 that the loans issued by these companies were in fact securities and should be registered with the SEC. So, both companies went through a long and expensive registration process to allow themselves to remain open to non-accredited investors and to comply with this decision.

To this day, these companies are the only peer-to-peer lending platforms to have undertaken this registration process, while there are dozens of platforms today, every other company is only open to accredited or institutional investors.

It should be noted that Lending Club and Prosper are primarily consumer lending platforms, that they have been doing quasi-small business loans since inception. Many small business owners use their personal credit to fund their businesses. I have done that myself in the past.

Since inception, Lending Club and Prosper have originated around $200 million in personal loans that were actually used for small business purposes.

In addition to these personal business loans, Lending Club has had their own small business lending operation for over a year offering term loans of between one and five years. Lending Club does not share their loan volume here but my understanding is this initiative is still relatively small but is growing quickly.

Prosper has a referral program with OnDeck Capital, the largest online small business lender.

I should explain the variety of products offered by the broader online lending industry. There are term loans such as what Sam from Funding Circle just described. Lending Club also does those. These are one to five year amortizing loans with relatively low interest rates.

There are lines of credit that can be drawn against as the need arises. This has a very wide range of interest rates. Merchant cash advance is the most high interest option. These are short term advances with repayments tied to credit card charges.

There is invoice finance, also known as "factoring," where small businesses can get immediate cash for their receivables. There is also crowdfunding which is often confused with peer-to-peer lending. It is not lending at all. It can be an equity based investment or it can be a rewards based donation.

What can government do? I appreciate the fact that you are having this hearing and you are interested in learning more about this industry. The continued growth of this industry will provide many benefits to small business owners and the economy as a whole.

As to what government can do, here I would like to describe some of the actions the U.K. government has taken. They provide a blueprint for supportive actions that a government can take to impact this industry. Number one, since 2012, the British Business Bank, which is wholly owned by the U.K. government, has been investing in small business loans issued by online platforms like Funding Circle in the U.K.

While the total investment is relatively small, this action has given the industry there a tremendous boost in credibility and trust among investors and borrowers.

They have also created a new regulatory framework specifically for the peer-to-peer lending industry. Last year, the U.K. government announced the creation of a bank mandatory referral scheme, where banks that reject small businesses for a loan must refer these businesses to alternative lenders.

I am not saying the U.S. Government should copy these actions, but rather they provide some ideas of how governments can support this burgeoning sector.

I firmly believe that small business lending is going through a transformation that will have a dramatic impact on the growth of small business in this country. I hope and trust that you will see the benefits we bring and will be supportive of this transformation.

Thank you.

Chairman CHABOT. Thank you very much. Each member will have five minutes to ask questions should they choose to do so. I will begin.

Mr. Hodges and Mr. Iyer, I will begin with you two. What are the common legal and regulatory challenges associated with peer-to-peer lending?

Mr. HODGES. Sir, I can go first. I think the biggest regulatory and legal challenge is frankly the complexity of having to deal with the overlapping set of Federal as well as state level rules, both on the lending or borrowing side, vis-á-vis how you provide capital to the small business owner, and then also on the security side, which is really around how you take those loans and then turn them into a product that allows an institution or an individual to put money to work.

We have invested literally hundreds of thousands of dollars, probably over $1 million, just in kind of figuring out the right framework for doing all that. I think some effort of simplification could be very beneficial.

Chairman CHABOT. Thank you. Professor?

Mr. IYER. When you really think about it, at some level, peer-to-peer markets when they originate loans and sell it to investors, you can think of them as junk bonds. They are basically issuing bad notes to investors. The problem is one has to be very careful of understanding what is the quality of the notes they are issuing, which is where the Securities Act really comes in to protect investors.

That is where the whole regulatory regime comes into play.

Chairman CHABOT. Thank you. Mr. Green, let me turn to you next. Could you elaborate on the P2P lender that you worked with and what made you confident that was the right option.

You have a sample of your product here. I know you do because I saw it before the hearing. If you wanted to show it, I certainly would not have any objection to that.

Mr. GREEN. Never miss an opportunity; right?

Chairman CHABOT. So we can see what you are talking about.

Mr. GREEN. Basically, through a series—we had a very generous line of credit through Bank of Kentucky, and one thing the Bank of Kentucky has been wonderful about, like Professor Iyer mentioned, they did not just look at our financials. They looked holistically at our whole entire business plan and what we had.

The problem with working with a much larger traditional financial institution, they wanted to see five consecutive years of profitability. I had only been in business three years, and very few startups are profitable in those early couple of years.

We were in a situation where we had to get access to capital within the next couple of weeks, and I had been seeing all this information on radio ad's and direct mailing pieces, and of course, never paying any attention to it until all of a sudden it came up as something I needed.

The reason we went with StreetShares was because they are a veteran owned company, and I think it comes down to trust. We both as borrowers have to trust the lenders and the lenders have to trust the borrowers. By having a marketplace that has veterans helping other veterans bidding on those loans, I feel it made me more comfortable to accept that loan. It has been a great access.

This is the sign that I want to see all those replaced with because you never need any batteries.

Chairman CHABOT. How is that different from the one we have in the hearing room here?

Mr. GREEN. This uses photoluminescent technology. Traditional exit signs use light bulbs and electricity and batteries. Those are all bad for the environment, they all cost a lot of money to maintain.

This uses a patented type of photoluminescent material, very similar to what was used in the World Trade Towers to help people find their way out, and as a result, we can save businesses hundreds of millions of dollars in ongoing maintenance costs and you never have to replace these.

They have literally a lifetime guarantee on them. Once you put them up, they work all the time, and in an emergency, when the power is out, that is the time you really need the exit sign with this, the photoluminescent, the glow in the dark is going to light up the whole entire area and show people how to get out safely.

Chairman CHABOT. Thank you. Mr. Hodges, let me go back to you for a moment. Funding Circle originated in the U.K., I believe, which is seen globally as the country leading the way for peer-to-peer lending, I believe.

Could you discuss some of the differences between the two countries, if you are aware of them, as it relates to P2P lending, and where we might be able to learn from the U.K.'s approach?

Mr. HODGES. Sure thing. I think the biggest difference between the U.K. and the U.S. from a regulatory perspective is in the U.K., we have a simplified regulatory framework that is specific to peer-to-peer or marketplace lenders, whereas in the United States, what you are really dealing with is a whole set of kind of archaic lending as well as securities rules.

On the security side particularly, the main laws that dictate how these businesses work are the 1933 Act, the 1934 Act, the Investment Company Act, and the 1940 Act. These are laws that did not really anticipate the Internet, and even subsequent measures to modify those really have not made it easier for businesses like Funding Circle to operate.

I think that is the biggest difference, specific regulation as opposed to kind of a mix of different older regulations.

I think the second big piece, as Peter mentioned before, is the U.K. government has decided that as a proactive measure for funneling capital to small businesses, this is a very effective thing to do.

The British Business Bank actually invests in a fractional piece of every single fractional loan that we do currently, which we are really excited about and it serves as a point of credibility.

In the United States, it would literally take an act of Congress to get the SBA to do something similar. There is just not necessarily the same kind of level of support.

Chairman CHABOT. Well, you have come to the right place for that. My time has expired. The gentlelady from New York, Ranking Member Velázquez, is recognized.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman. Mr. Renton, as the CEO of both Lend Academy and LendIt Conference, what are the most asked questions you receive from prospective small business borrowers looking to use peer-to-peer lending?

Mr. RENTON. The most asked question I receive is can you please fund my loan. That is what most people want. Seriously, what small business borrowers want to know is are they getting ripped off. They want to basically know that the options that are available to them are appropriate, and they also want to know what is the quickest, as Zach just talked about, he needed funds quickly. That speed is one of the themes. They know a bank is going to take one or two or three months. They need something quicker than that. They want to know what their options are.

Ms. VELÁZQUEZ. Mr. Hodges, how do we balance that? Small businesses, they need money, they need it now, and how do they know what they have been offered is transparent, that there are not hidden fees? How do we balance that?

Mr. HODGES. For us, it really comes down to transparency. From the very moment that a small business comes to our site and uses our effective rate calculator to figure out how much the cost of financing would be, we are completely transparent about the interest rate, our origination fee, and any other potential fees that a borrower might pay over the lifetime of the loan.

I think it is ultimately kind of around transparent practices, that is what in many ways sets this segment apart from other lenders.

Ms. VELÁZQUEZ. Mr. Renton, so many times, right after the financial crisis in 2008, where credit was tightened by financial institutions, we held so many hearings here about the inability of small businesses to access capital, but most importantly, smaller loans.

When we questioned traditional financial institutions, they said smaller loans were too costly. Now, we hear that according to one industry expert, institutional investors now account for 80 to 90 percent of the lending taking place on peer-to-peer platforms. Are you seeing this trend?

Mr. RENTON. Yes.

Ms. VELÁZQUEZ. How can we explain that? On the one hand, they do not lend through traditional markets; right? Now, they are taking advantage of this. Is that because of traditional banking regulations that they are trying to circumvent?

Mr. RENTON. I do not think so. First, let's address the first part of that question. There is no doubt that institutional investors are looking at this as a class and devoting a lot of capital to it.

I want to defend the retail investor. I am a retail investor myself, have been for many years. I have found that there was a time a couple of years ago where they had to make some tweaks to their systems but today, retail investors get a good deal. Retail investors can invest on Lending Club, on Prosper, on Funding Circle. They can invest in loans, and the playing field is level. They have made it that way.

As to institutional investors, why they are doing it, obviously, they are doing it for yield. These are often people or institutions that were not involved in the lending business at all. There are some hedge funds, there are some insurance companies.

These are companies that for the most part are new to the lending industry. They were deploying capital that might have gone into the equities market or the bond market and they are deploying it into this industry.

Ms. VELÁZQUEZ. Thank you. You do not see any type of impact on the retail investors?

Mr. RENTON. I do not see a negative impact.

Ms. VELÁZQUEZ. Good. Thank you. Mr. Green, the SBA, Small Business Administration, has a nascent presence in the peer-to-peer lending market. If the Small Business Administration were to get more involved, what would you like to see them do for small business owners like yourself?

Mr. GREEN. We actually did start working with the SBA for one of the loans that we ended up walking away from, and the reason was strictly it took too much time. There was just too much paperwork, there was too much red tape, there was just too many hoops to run through.

In a small business, one week in my business is like a year in a Fortune 500 business. We do not have the time to go through all that type of—for lack of a better word—red tape to get through that. If they do get involved, we would like to see them speed the process up.

Ms. VELÁZQUEZ. Thank you. My time is up. I had a question for you, sir, but——

Chairman CHABOT. We will give the gentlelady an additional minute if she would like to go ahead.

Ms. VELÁZQUEZ. You made a statement before while you were giving your testimony where you said that you could effectively judge risk over the Internet. Can you explain that a little further?

Mr. IYER. At some level the measure of risk is basically how you can predict the likelihood of default based on something you are lending on, so credit score, 700, 750, 600. If you look at where the credit score predicts default, and the interest rate which lenders bid in predicting default, you find that the interest rate where these platform lenders come together and bid has a much better predictive power in terms of default as compared to just using the credit score.

Ms. VELÁZQUEZ. Thank you.

Chairman CHABOT. The gentlelady's time has expired. The gentleman from Missouri, Mr. Luetkemeyer, who is also the Vice Chairman of this Committee, is recognized for five minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chair, and thank all of you for being here today. It is a great subject to discuss here. I have lots of questions.

Just a minute ago, Mr. Iyer, you made the comment about bidding by the investors. Do these investors say we have to have X amount of percent return on our investments or do they take what you give? How does this work?

Mr. IYER. What happens is you post a loan, you say I want to borrow $10,000 at 10 percent or whatever. The investor decides how much they want to fund. They could say I am willing to put in $1,000 for X percent, so there is like an auction which happens. As soon as the whole amount gets bid on, the lowest interest rate goes to the borrower, exactly what happened to Zachary.

Mr. LUETKEMEYER. Mr. Hodges, you are in the business. Do your investors bid?

Mr. HODGES. In our case, we actually set the price. What we found historically is actually the pricing that an auction mecha-

nism would dictate is driven more by liquidity than the actual underlying credit risk.

Mr. LUETKEMEYER. What is the actual return your investor gets for investing money with you?

Mr. HODGES. It really depends on how much risk appetite they have. If they want to invest in safer loans, then you are talking about an effective yield to the investor in the mid to high single digits. If they are willing to go out the credit spectrum a little bit and take more risk and more volatility, then we have investors who are earning in the low teens.

Mr. LUETKEMEYER. I think you said you have $1 billion you are trying to put out or you have had out, this last year. What is the percentage of loss you have on that?

Mr. HODGES. Our global annualized loss level is about two percent. It varies a lot by credit tier. Our safest credits are A+ credits. It is well under one percent. For riskier credits, as you move out, it can be as high as five or six percent annualized.

What we are really trying to do is just provide a fair price, a fair and transparent price that gives investors sufficient return while at the same time making sure that the money the borrower is getting is priced inside their own return.

Mr. LUETKEMEYER. How easy is it for the investor to divest themselves of this loan or security that they purchase through you? In other words, let's say I invest $100,000 with you, but two years from now I want my money back or I think the company that I have invested with is going south and I want to get out, how easy is it for me to divest myself of that investment?

Mr. HODGES. This works quite differently in the U.K. where we have a good chunk of our business versus the U.S., given the actual securities regulations.

In the U.K., we actually have the world's most active secondary market of any peer-to-peer lender, so a meaningful share of our fractional notes, the actual investments of loans, are actually traded on a secondary basis, which we are really excited about.

Unfortunately, in the U.S., the way the securities rules are written, it is actually much harder to do that. There are both state level Blue Sky laws as well as Federal laws that make it difficult to craft a secondary market.

Mr. LUETKEMEYER. Once I invest with you, I am locked in pretty well?

Mr. HODGES. Correct. People are taking illiquidity and we are very transparent about that.

Mr. LUETKEMEYER. Do you have a particular industry that you specialize in and provide funds for or do you do across all industries?

Mr. HODGES. We are very diversified. No one industry accounts for more than about eight percent of the bucket.

Mr. LUETKEMEYER. Mr. Iyer, you talked about soft information. Can you explain what soft information is?

Mr. IYER. Now there are two models in the peer-to-peer market which are competing. One is the model that the intermediary platform decides to rate, the other is investors like Zachary was saying who decide what is the rate and how much they bid. Soft information could be anything which is non-verifiable. Credit score is hard

information, which is based on your past credit history, past payments, and other things.

Soft information could be somebody says I am a veteran fighter, I basically did this, X, Y, Z, you have a picture, anything that is non-verifiable, subjective, we put it in the bucket of non-standard soft information.

You actually find that for people with low credit scores, investors use a lot of soft information as a screening mechanism.

Mr. LUETKEMEYER. They have an algorithm put together that they can figure this out.

Mr. IYER. Yes.

Mr. LUETKEMEYER. I have seen this before. This is very interesting stuff. Mr. Renton, a quick question for you. There have been a couple of comments about needing some government intervention here, and I always kind of cringe, it is like be careful what you wish for here.

Have there been any abuses that you have seen in the marketplace with the different peer-to-peer lending groups or people who accumulate money, the crowdfunding? Is there something there we need to be watchful for, that we really need to take a look at, the rules we have in place, are they sufficient right now?

Mr. RENTON. As far as abuses go, there have really been no cases of abuses on the platform level. Of course, there are always going to be borrowers who are looking to commit fraud, and for the most part, the platforms do a very good job of really isolating those and rejecting them.

As far as on the investor side and the platform side, there has been no cases of abuses whatsoever.

Mr. LUETKEMEYER. At this point, you really do not need to have a lot of government intervention, the system is actually policing itself well enough?

Mr. RENTON. Yes, I think it would be nice if there was some specific guidelines for this industry, but I think the system as it is today is working.

Mr. LUETKEMEYER. I see my time is up. Thank you, Mr. Chairman, and thank all of you for being here today.

Chairman CHABOT. The gentleman's time has expired. The gentleman from New Jersey, Mr. Payne, is recognized for five minutes.

Mr. PAYNE. Thank you, Mr. Chair, and to the Ranking Member. Kind of along that line, Mr. Iyer, this question really goes to customer service and the possibility of hidden fees and what have you. What recourse does a person have with peer-to-peer lending sites when something goes wrong?

Mr. IYER. You mean the borrower or the lender?

Mr. PAYNE. The borrower.

Mr. IYER. I guess when you say something goes wrong, he has the money, right? Once the bidding is done and you get the money, you have the funds, so you are the one who can basically make things go wrong. You can default. From that side, the intermediary is the one who is held hostile by the borrower.

The risk is there are hidden fees and things which are——

Mr. PAYNE. That is what I was getting at.

Mr. IYER. I guess these markets are quite transparent in the sense that they charge hardly any fees which are opaque, they are actually very transparent in that sense.

I guess the risk of borrowers is pretty low because you can see exactly what you are getting into.

Mr. PAYNE. Has there been any research done in economic demographics of most lenders, the types of businesses they fund, and in what geographic areas?

Mr. IYER. That is a very interesting question. Unfortunately, the lenders are anonymous. In all these peer-to-peer platforms, you only see the borrowers. You do not know who is funding what kind of loans and whether they have expertise in funding. That is a question which I do not think I would be able to answer.

Mr. PAYNE. Mr. Renton, we heard earlier on the average, eight percent of business loan applications are accepted in the peer-to-peer platform. Can you elaborate on why you think that may be the case, and what can we do to increase that number, if you think it should be increased.

Mr. RENTON. I think the eight percent number refers to the consumer side of P2P lending. On the small business side, Sam could obviously give you the exact number for his platform. I believe it is much higher than eight percent.

Having said that, there are still rules and guidelines these platforms put in place.

If you are a start-up with no history, it is going to be hard for you to find a loan. If you have never made money in the history of your business, you are going to find it hard to get a loan through the major online lending players.

Mr. PAYNE. That is sort of the interesting aspect of this, how does someone get started. Your point was you needed five years but you only had three. How do you overcome that obstacle, Mr. Green?

Mr. GREEN. This is the entrepreneur's dilemma, you need money to buy product and to start marketing, but yet without any revenue stream, how do you get that started, what comes first, the chicken or the egg type thing. It is tough, and it is not only tough to get started, it is even tougher—someone said success is the hard part, failure is easy. It is the success to continue on and to grow.

I got nervous when I got these large deals coming in, do I have enough capital to be able to put the materials together in the early days. Now, I am confident we can do that, but early on, it is a constant challenge.

At the end of the day, you have to have—you can look at all the financials in the world, it comes down to do you believe in the entrepreneur, do you believe they have a pure heart and a good idea and they are solving a problem in an unique way, and if they are, put the risk in there and invest.

Mr. PAYNE. I was going to mention that, in your case, you are fortunate that you came up with a great idea, and something that is necessary and useful in society. Has that made it a bit easier for you to have people kind of go along with investing?

Mr. GREEN. It does. I think somebody had a really good point, they said when you are a successful entrepreneur, you need to solve a complicated problem in a very unique and eloquent way, you have to have an unfair competitive business advantage, and

you also have to have really incredible marketing sales and distribution.

When you can put all three of those together, it makes it a lot easier to get not only equity based financing but also debt based financing. The challenge with debt based financing, most of the time the larger banks just only want to look at the spreadsheet and they do not look at it holistically.

Again, what Dr. Iyer shared is so true, and we saw that with our small regional lender, they looked at the why rather than just strictly the numbers we had in the past.

Mr. PAYNE. Thank you. I yield back.

Chairman CHABOT. Thank you. The gentleman's time has expired. The gentleman from New York, Mr. Gibson, is recognized for five minutes.

Mr. GIBSON. I thank the Chairman, another informative hearing. I thank both the Chairman and the Ranking Member. Thanks to the panelists as well.

Help me better understand this piece here. I can imagine a number of factors why individuals would be turned down for a conventional loan. Help me understand a little bit better maybe with some finer resolution how someone sort of misses that but gets into your window, your eight percent, why that would be unattractive to a conventional loan yet attractive to the industry.

Mr. HODGES. I guess I can take a first crack at the question. I think it is a very good one. I guess my own perspective on this is most banks use a check list based underwriting approach where a small business needs to meet all of a variety of different criteria, number of years in business, amount of revenue, type of industry, particularly if it is a cyclical industry, they may not lend at all to, amount of tax return profitability, particularly in the early days when small businesses do not run with tax return profitability, and so forth.

Whereas, in our case at Funding Circle, we are really looking to develop a comprehensive perspective on the business. We understand on a forward looking basis what is going to be the cash flow of the business and can that business support a loan. If so, we are happy to lend to them.

It is really the flexibility of our underwriting model and also the flexibility of our pricing that allows us to offer credit to many small businesses who otherwise do not have access.

Mr. GIBSON. Thanks. Just to follow up on that, have you ever had for Funding Circle an independent audit of some kind, and are there any industry ratings in this field?

Mr. HODGES. To my knowledge, there are no industry ratings, per se. There are certainly consumer ratings. For example, we use Trustpilot to gather feedback from our customers. We also track very carefully our net promoter score. Our net promoter score in the U.S. is about 70 percent, which we are really excited about, and in the U.K., it is 89 percent. It is actually a pretty high level.

Beyond that, I guess in terms of how we are evaluated, it is more around auditing specific operational practices that we use, and particularly now that we are partnering with banks, actually on a referral basis. We have actually gone through pretty extensive audits just to make sure every piece of the business is really clean.

Mr. GIBSON. Any other comments from the panel?

Mr. IYER. I would just make one comment which is where this industry is heading. In a sense initially you used to see stuff that people used to post and other people used to bid. Now, what is happening is a lot of platforms are doing the screening themselves.

The platform Zachary was talking about allows people to bid. The platform Sam was talking about bid inside the screening. I think there are merits to both, but I think it is something that if somebody gets turned down, they should have the option to go on to a reverse auction site, just in case they got it wrong and investors have a choice to get funding because they might want to lend.

That is something the market has to decide, but that would be a viable alternative.

Mr. RENTON. I think that is happening. I know people that are going to multiple sites at the same time because they want to see the different rates. I do not see anything wrong with that. I think there are different models out there, as Raj was saying. The predominant model today is the fixed price model where the platform sets the risk. Whether that wins out in the end remains to be seen, but that is certainly the most predominant one today.

Mr. GIBSON. I thank you, gentlemen. Your testimony has been helpful to me. I yield back, Mr. Chairman.

Chairman CHABOT. Thank you. The gentleman yields back. The gentlelady from North Carolina, Ms. Adams, is recognized for five minutes.

Ms. ADAMS. Thank you, Mr. Chairman, Ranking Member Velázquez, and thank you, gentlemen, for your testimony.

I agree that small businesses are the engines that drive our economy. Over the past several years, we have seen a severe credit crunch within our financial markets, banks have not given loans at the same rate as previous years.

With that in mind, Mr. Hodges, let me ask you about Funding Circle, which was founded based on your experiences as a business owner who had difficulty getting access to credit. With Funding Circle being one of the largest peer-to-peer lending sources, can you share potential market threats, both financially and technologically, that peer-to-peer lenders currently face or that you foresee may deter lending?

Mr. HODGES. At this point, what I would say is even though some of us are getting to scale, we are still very much in the early days of developing the business. Small business lending, term lending, is a $270 billion market in the United States. If you put in kind of shorter term lending, it is probably closer to 600 or $700 billion. None of us are really meaningful yet.

I guess what I would say is cutting through the noise, small business is a very fragmented market, cutting through the noise and making sure that a small business owner really understands what your product does and how it is differentiated from what else is out there is one of the major things that we focus on.

In terms of kind of competitive threats or big looming hazards, there is nothing that is really keeping us up at night. It is really just around operating the business in a very reliable way and making sure we are scaling in a responsible fashion.

Ms. ADAMS. Thanks. Can you tell us a little bit about the demographics of the businesses your company services?

Mr. HODGES. Sure. Our borrowers are all across the country, and they also range very widely in terms of their ethnic, education background, certainly gender as well, and we are very proud of the lots of different stories of small business owners who have had very bad experiences with the banking system but who subsequently have taken loans from us.

In terms of the type of business, it can range all the way from kind of retailers, service businesses to consumers, through light manufacturing and logistics, to B to B businesses, businesses that are serving other companies.

What we have developed is an underwriting framework and an origination approach that allows us to serve a very broad base.

Ms. ADAMS. Peer-to-peer lending is a very good model for some communities, but many minority owned firms with the capacity to move to the next level need different types of access to affordable capital, and still many of these firms jump higher for less.

What models or policy recommendations can you offer to the Committee that we might explore that would be beneficial to minority owned firms on both traditional and non-traditional platforms?

Mr. HODGES. I think the place that we start is around self regulation of non-bank lenders. We are working currently with a number of other players in the space to make sure that we all have very responsible standards around disclosure, around the effective rates that we are charging through, and also our collections and servicing practices.

Historically, if you look at what has gone bad in small business lending, those are certainly areas where problems have occurred.

In terms of policy recommendations, I guess what I would say is for now many of us are really focused again on self regulation. That being said, to the extent that disclosure particularly came up as something folks could take a closer look at, I do think disclosure around rate and kind of effective financing charges might be a good place to start.

Ms. ADAMS. Thank you. Would any of the other gentlemen like to respond to that question?

Mr. GREEN. I think a great idea knows no color, no religion, no background. If you have a great idea and you are able to put it out there and the market supports that and they see that, hopefully the funding will come along with that.

Ms. ADAMS. Mr. Renton?

Mr. RENTON. I would just say one of the great things about these online marketplaces is they operate online, so geographically, they are completely open to everybody. It is not like there are certain banks that do not operate in certain areas or you have to travel two hours to go to your local bank. The great thing about online is it is convenient to the entire country and there is no discrimination whatsoever when it comes to access.

I think having that be a central tenant, and the other thing I would say is there has been talk about partnerships with CDFIs, which I think is still in its infancy, but CDFIs and community banks could very well use some of the technological know-how

these online platforms have. I know there has been some talks in this area. I think that is somewhere organizations that serve these underserved areas can really benefit.

Ms. ADAMS. Thank you. I yield back, Mr. Chairman.

Chairman CHABOT. Thank you. The gentlelady yields back. The gentleman from New York, Mr. Hanna, who is the Chairman of the Small Business Subcommittee on Contracting and Workforce, is now recognized for five minutes.

Mr. HANNA. Clearly, you are not in the Heifer projects. I am thinking back to Michael Milken, he was way ahead of his time, and I give him credit for that. I do not think he would be in the same jam today if he was doing what you are doing.

The information that you provide your investors with—I love what you do, I think it serves a great purpose, and I think in the marketplace it fits as long as there is transparency.

Mr. Hodges, to be frank, you may have a small loss ratio but loss ratio's are measured over time. That might be last year's, next year's could be much worse.

I am curious about the due diligence that you provide other than the obvious quality of diversity that you have, which is a big piece of it, how do you say to people what are your lower limits? Maybe this was asked, I apologize for being late. How do you inform people who are giving you large amounts of money what their true risk is?

To revisit Mr. Milken, over history, his was extremely low, not that much more than any other bond.

Mr. HODGES. Similar to how we think about the borrower side of our business, also on the investor side, it is really around transparency and disclosure. What I mean by that is when an investor comes to us, be it an individual or institution who wants to buy loans or pieces of loans through us, what we provide is really detailed information about historically how a business credit has performed at different points in the cycle.

We also provide full disclosure on our current loan book, and lastly, on a loan by loan basis, we provide very detailed financial information on a go forward as well as historical basis that allows them to understand what is the debt service coverage ratio, which is really the business' cash flow ability to pay back the loan, the level of asset coverage, and also some of the characteristics of the business itself.

Mr. HANNA. What do you look for in a net worth of a guy or woman who is going to send you a check to invest?

Mr. HODGES. In the United States, we limit our marketplace to accredited investors only, so they have to meet the SEC accredited investor——

Mr. HANNA. Which is what, $1 million?

Mr. HODGES. It is $1 million net worth outside of your home.

Mr. HANNA. When you are speaking to minority groups and their ability to access what you do, not just minorities but anybody who might want to borrow money, there are lower limits to the borrower, too. You have lower limits for the investor. What are the lower limits for the borrower? How far down the food chain do you go?

Mr. HODGES. Currently, our limits on the borrowing side are the business needs to have been around for at least two years, so two years' worth of tax return information, so we can really assess how that business has performed and make some prediction around how we think it will perform in the future.

Secondly, the individual behind the business needs to have a FICO score of 620 or higher. We use that as a qualification criteria. It is actually a minority of the signal we use to eventually approve the loan.

The business needs to have been profitable in at least one of the last two years. Obviously, if the business has been around longer than that, and most of our businesses have, our average business has been around for about eight years, then it is easier to get a gauge of profitability.

Those are really the fundamental qualification criteria just to be eligible for a Funding Circle loan at this point.

Mr. HANNA. You feel pretty good about the future. With all this due diligence on your part and informing people and setting those standards for borrowers, you must have done projections on your own expectations of loss, and if your returns are X, do you subtract that?

Mr. HODGES. We have done extensive kind of testing and analysis around how our current book would perform either in an economic downturn or in an environment with meaningfully higher interest rates. What we see is certainly the loss rates, default and loss rates would go up meaningfully, but still, an investor who is sufficiently diversified, meaning they hold pieces of at least 100 loans, actually would not lose any principal based on the stress testing we have done.

Mr. HANNA. Do you feel you are at least 100 percent covered on the bottom side?

Mr. HODGES. Never would say 100 percent covered. There is always idiosyncratic risk.

Mr. HANNA. That is sort of what you just said, but I appreciate where you are going. Thank you. My time has expired.

Chairman CHABOT. Thank you. The gentleman yields back. The gentlelady from New York, Ms. Clarke, is recognized for five minutes.

Ms. CLARKE. I thank you, Mr. Chairman, and I thank our Ranking Member, Ms. Velázquez. Let me thank our witnesses. This is a very intriguing and important subject we are discussing today because access to capital, we know, is a fundamental building block for small businesses in the United States.

During the financial crisis of 2008, it led banks pulling out $116 billion in the lending market. This has compelled small businesses to seek the necessary loans from non-traditional lending sources, such as peer-to-peer lending.

We have seen that these peer-to-peer lending marketplaces are subject to high risk and potentially fraudulent services or activities. What suggestions might you have to improve the regulatory climate and oversight environment for peer-to-peer marketplaces to counteract practices of fraud or other elicit investing practices? Have you thought that through?

Mr. RENTON. As I said earlier, there has actually been no cases of fraud in this country on the platform side. The borrower side is a different story, on the consumer side. Sam can probably talk about his experiences with fraud.

Fraud on the platform side, which is a problem in some countries, it simply has not been a problem in this country, and I think even though there is a myriad of rules and regulations that these platforms have to adhere to, for the most part that works when it comes to deterring fraud.

Ms. CLARKE. Are you saying there is no necessity for that in the United States? Is that what you are saying?

Mr. RENTON. Yes.

Ms. CLARKE. Yes, you are saying there is no necessity to put any safeguards or regulations in place because fraud is non-existent?

Mr. RENTON. The safeguards that are in place today are sufficient to deter fraud. That is what I am saying.

Ms. CLARKE. Very well. Sam? Excuse me, Mr. Hodges.

Mr. HODGES. If I can speak on that directly, I guess on the platform fraud side, what I would say is we are already heavily regulated. We are regulated as a securities business. We own a broker-dealer. All the information we provide to our investors who are buying pieces of loans through us have to comply with the disclosure standards the SEC has set up and other securities law for any private offering.

Certainly, making sure that what we send to investors to make sure they are making good decisions is a really important piece of the business, but I think those rules are already fully in place.

On the borrower side, fraud is an expensive problem. We and other platforms have been hit extensively by fraud rings in the United States, and that is one of the things we are working together on, just to make sure we can identify fraud and weed it out.

Ms. CLARKE. You also believe that you have set standards sufficient enough to address risk and how the risk is distributed among the investors?

Mr. HODGES. I guess what I would say is yes, particularly on the fractional side. On the institutional side, for us and many of the platforms is a whole owned business, those are very large institutions who are investing millions of dollars, and we work with them to structure arrangements where they are getting sufficient information as well as sufficient diversification to make sure they know what they are getting.

On the fractional side, as I said, there are already extensive rules in place which we follow insidiously just to make sure our investors are protected fully.

Ms. CLARKE. They do know what they get?

Mr. HODGES. We believe so.

Ms. CLARKE. Okay. Very well. My second question quickly is with the increased popularity of the peer-to-peer lending platforms, we are seeing an increased rate of rejection for small business applicants through these platforms. This can lead to a gap in access to capital for our small businesses which can result in small businesses closing their doors.

What suggestions might you have for Congress to implement that would be conducive for small businesses to continue to be able to access the capital they need through the peer-to-peer lending platforms?

Mr. HODGES. One idea borrowing from what we have seen in the U.K. where we also operate is also having turn down requirements, where if a bank is going to go and turn down a small business for credit, they actually have the responsibility to send that small business somewhere else, so the small business owner knows there are other options. If there was one policy measure, I think that would be it.

Ms. CLARKE. Very well. I thank you, gentlemen, very much for your testimony here today. I yield back, Mr. Chairman.

Chairman CHABOT. Thank you. The gentlelady yields back. I want to apologize for the mike. I think the gentlelady was correct, I do not think it was working properly. We will definitely look into it and take care of it.

I would now like to yield to the Ranking Member who has one final question.

Ms. VELÁZQUEZ. Just one final question. I represent New York, my congressional district is in New York. Part of my district was devastated by Sandy. A lot of small businesses suffered because the financial assistance they needed in terms of disaster loans took too long for SBA and FEMA to process.

We all know that when natural disasters strike, if small businesses do not get the financial assistance they need, a lot of those businesses might have to shut down. Forty percent of small businesses do not reopen after a disaster.

My question to you is in the aftermath of Hurricane Sandy, small business recovery was hampered by the slow disaster loan process. Did your platform fund any businesses in Sandy impacted areas, and do you think peer-to-peer lending is a viable option for disaster recovery?

Mr. HODGES. We certainly have made loans to small businesses in the Sandy disaster area. As a matter of fact I remember anecdotally a number of businesses who had interruptions in their operations and were really looking to get back on track and coming in and applying for credit. Yes, that is something that we have seen.

In terms of whether this is an effective measure for disaster recovery, to be honest, it is not something we have taken a really close look at, but certainly what I would say is when we see an opportunity in the market where there are going to be a concentration of small businesses who kind of need to expand, need to grow, need to invest in their store front and equipment, those are opportunities where we just frankly go and market more. There is kind of a factor that already makes it happen.

Mr. IYER. There has been some studies done on disasters in other places, and they have looked at these markets when they were serviced by payday lenders after the disaster strikes as compared to when peer-to-peer platforms came up, and they do find recovery from these shocks are much better because of these people that go to peer-to-peer platforms and post a listing for a loan and they get it.

In a sense, the information of whether people can access these platforms, maybe people do not know so they do not post it, but if that is available, these platforms are useful.

Mr. RENTON. I really think it is a great idea. One of the things these platforms have an advantage over is speed. They can move very quickly. This is still a pretty nascent industry, and there is not a whole lot of infrastructure in place compared to the traditional banking system.

I think Sam can probably talk about this, I think if there was some sort of arrangement in place that encouraged the platforms to really focus on the hard hit areas, they could move very quickly, I think.

Ms. VELÁZQUEZ. All these businesses have insurance, but they need that immediate financial assistance, such as a bridge loan through SBA, until the insurance money come through.

Mr. RENTON. There are also other online platforms that are not really peer-to-peer but that operate in a similar way from the borrower side that are even faster. There are companies like Cabbage and OnDeck that provide cash to businesses literally within minutes. Those are the sort of platforms that would also be able to work much quicker than the traditional bank.

Ms. VELÁZQUEZ. Thank you.

Chairman CHABOT. Thank you very much. The gentlelady's time has expired.

I want to thank the entire panel. You all did really a great job in testifying here. We really appreciate your time. We know you have other commitments, and you came here to help members of the Committee to better understand the entire peer-to-peer lending process, your perspective on it, and as we all know, it certainly is an alternative.

It is one of the important ways that small businesses nowadays can have access to capital, and that is a critical element in a business being successful, and as we grow small businesses, we are growing jobs in this country.

I think we all agree we need to do a better job doing that, so we can have the unemployment rate come down and have every American who wants a job have access to one. We want to thank you for your contributing to that cause.

Members have five days to submit statements and supporting materials for the record.

If there is no further business to come before the Committee, we are adjourned. Thank you.

[Whereupon, at 12:20 p.m., the Committee was adjourned.]

A P P E N D I X

CONGRESSIONAL TESTIMONY

"Bridging the Small Business Capital Gap: Peer-to-Peer Lending"

Testimony before

The Committee on Small Business

United States House of Representatives

May 13, 2015

Rajkamal Iyer,

Associate Professor of Finance,

MIT Sloan School of Management

My name is Rajkamal Iyer. I am an Associate Professor in Finance at MIT, Sloan School of Management. I would like to express my thanks to Chairman Chabot, Ranking Member Velázquez, and members of the committee for the opportunity to be here this morning.

I became interested in the peer-to-peer credit markets when I learned how these new online markets have been developed to improve access to credit for small businesses and individuals. What was interesting about these markets were that the loans were funded by a group of small individual investors as compared to sophisticated lenders. Given that one of the big problems of credit markets in general, is screening for the underlying creditworthiness of borrowers, I was interested in understanding whether small individual lenders can judge creditworthiness effectively.

Therefore, with my coauthors Asim Khwaja at Harvard University, Erzo Luttmer at Dartmouth, and Kelly Shue at the University of Chicago, we set out to understand the functioning of these markets. The context we studied was an online lending platform, Prosper.com, where individuals can lend to their peers. Individual lenders decide which peers to lend money to by using both hard and (mostly self-reported and non-verified) soft information on borrowers to determine their creditworthiness. Our paper shows that non-expert individuals do remarkably well—they are not only substantially better at predicting borrower default compared to predictions based on exact credit scores, but also do well relative to an econometrician's best predictions given the data available. In particular, the interest rate set by lenders predicts default 45% more accurately than the borrower's credit score.

Our results show that lenders in peer-to-peer markets are able to effectively infer borrowers' creditworthiness using the rich information set that these markets provide. We further find that lenders rely on nonstandard or soft sources of information in their screening process and that such information is relatively more important when screening borrowers of lower quality. Our results highlight that even markets with non-expert individuals can effectively screen for borrower creditworthiness. Given peer-to-peer markets' ability to effectively screen borrowers, and given their non-collateral-based lending structure, such markets can offer a potential capital source for small borrowers who may otherwise be limited to more costly sources of finance.

So one could ask what are the risks in these markets? One could be worried that investors are making bad loans and as they cannot judge borrower quality. Given the findings, this does not seem to be the case. What are the benefits to small businesses? Even if the interest rates offered by these online markets are similar to the those offered by banks, the growth of these markets could benefit small businesses as it could provide them with more funding options. At this point, given the nascent nature of these markets, regulating them could create impediments for their growth. Having said that one needs to keep track of how these markets evolve before designing regulatory frameworks to mitigate any possible externalities that might arise.

Thank you again for the opportunity to address the Committee. I will be happy to answer any questions.

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Bridging the Small Business Capital Gap: Peer-to-Peer Lending

Sam Hodges – Co-Founder and Managing Director, Funding Circle USA

May 2015

Opening Acknowledgments

Mr. Chairman, Ranking Member Velazquez, and Members of the Committee. I am Sam Hodges, co-founder of Funding Circle, and a small business owner myself. I am here to talk about how peer-to-peer ("P2P", also known as "marketplace") lending is playing a vital role in delivering capital for great small businesses all across the country, filling the gap left as banks have pulled back from this important segment.

Before founding Funding Circle, I was very much like the aspiring entrepreneurs and hard-working small business owners in your districts. Starting in 2009, my partners and I built up a successful chain of fitness businesses all across the country. As we pushed to open new locations, however, we found that, despite strong traction and personal credit, we were repeatedly denied a loan that could help us grow our business. That experience informed our decision to launch Funding Circle, as a better way for small businesses to get loans. As you know, all across the country, America's small business owners work around the clock to serve their customers and their communities, create jobs, and support their families. As members of this Committee, I am sure you share our conviction that making sure that the rules of the road for these small businesses are well laid is a critical element for ensuring prosperity in our country.

Introduction

Founded in 2010, Funding Circle is the leading global marketplace lender dedicated to small businesses. Over the past five years we have helped over 8,000 small business owners obtain over $1 billion in loans. We currently lend out approximately $75 million dollars per month to a wide range of small businesses in both the US and the UK – from a logistics business in the Midwest, to an education services company in suburban Atlanta, to a multi-unit salad company in San Francisco, we are helping the 28 million small businesses in the United States gain access to the capital they need to grow and expand. Our average loan size is $125,000 and our average borrower is a business that has operated for eight or more years, has ten or more employees and earns over $1 million annually in revenue. Our borrowers are the bedrock, growing, main street small businesses that power our economy. Not only are our loans delivered quickly and in a highly-transparent fashion, they are also fairly priced, with interest rates typically in mid-single digits through the mid-teens, and in increments of $25,000 to $500,000 over a one to five year term. Our loans address the core of the small business credit gap: term loans that a small business owner can use to expand her store front, open a new location, hire more staff, or launch

a new product. These loans resemble the type of loan that local banks made to small businesses two or three decades ago but which, more recently, have largely dried up.

As you know, small business is a key pillar of American economic strength. Small businesses provide roughly half of American jobs, account for a majority of new job creation since 1995 and also serve as critical onramps for small business owners to broader prosperity – which in turn helps address income inequality.[1] Yet, if you ask the average main street small business owner whether they have the credit access they need to grow and expand, most likely the answer you will hear is a resounding "no." Even as our domestic economy experiences a recovery, many small businesses remain left behind by banks who largely do not view smaller-dollar commercial lending as core to what they do.

Many of these topics around small business capital access have been well trod by other congressional witnesses, so I would like to tighten my focus to three parts of the story that to-date have not been well-told in this forum: first, I will briefly provide an overview of my company, Funding Circle, and the role that we and other marketplace lenders are playing in this part of the economy; second, I will address why the Jumpstart Our Business Startups Act (the "JOBS Act") presents a missed opportunity so far in terms of facilitating access to capital for small businesses in the United States; and, finally, I will share how the rise of responsible marketplace lending could transform access to high-quality, non-bank credit for the majority of American small businesses that otherwise remain stuck with only high-cost, short-term products.

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Background on the P2P and Marketplace Lending Industry

The past decade has seen the development of a new category of lenders: marketplace lenders (oftentimes also referred to as "peer-to-peer" or "P2P" lenders) provide a radical, new and transparent way of connecting providers of capital – lenders – with consumers and small businesses who need it to fund investments and/or consumption. Put simply, we and other such platforms provide a digital marketplace format, supported with advanced credit analytics, to match the supply of capital with demand. The earliest marketplace lenders – Zopa in the UK and LendingClub and Prosper in the US – focused on delivering capital to consumers seeking capital. Over the past six years we at Funding Circle and other platforms around the world have applied a similar concept to an even more important category: getting capital in the hands of small businesses who need it the most. The following diagram summarizes how our marketplace works:

[1] Karen Gordon Mills & Brayden McCarthy, *State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game* (Harvard Business School Working Paper 15-004, July 22, 2014).

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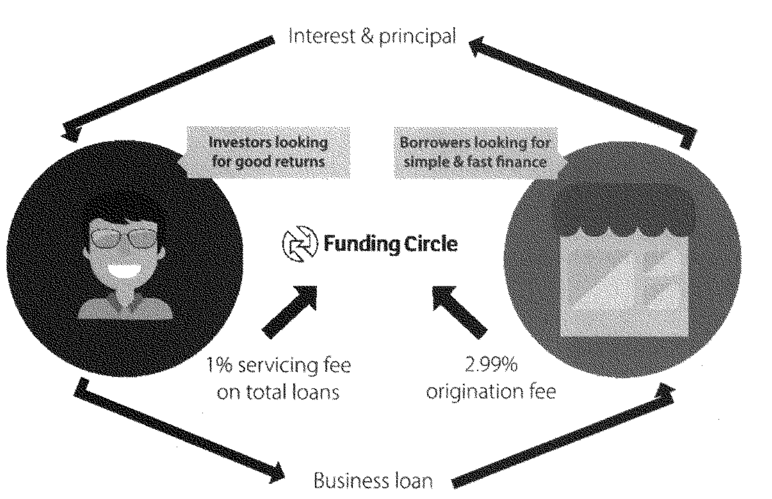

Exhibit 1: How Marketplace Lending Works

From our experience in talking with bank partners, small businesses owners, and investors who lend through our platform, we have identified four key reasons why this category of lender is emerging as so successful: [2]

1. **Regulatory Pressures on Banks.** The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and other post-financial crisis regulatory frameworks dramatically increased compliance costs for banks. The Basel Accords require banks to increase and improve their capital ratios by holding more capital against many loans they make. These factors make certain types of lending very expensive and generally less attractive than other areas where banks can make more money.
2. **Shifts in Distribution Costs and Consumer Preferences.** Most banks maintain extensive brick-and-mortar distribution networks. While helpful for some lines of business, this distribution channel is very costly when it comes to smaller loan sizes (less than $1 million in many cases). At the same time, many small business owners are busy running their businesses and prefer to apply for credit online, in the same way they obtain an increasing number of services. The hard truth is that for many banks it is simply not

[2] For additional research and analysis on this point, *see* Charles Moldow, *A Trillion Dollar Market By the People, For the People How Marketplace Lending Will Remake Banking As We Know It* (Foundation Capital Working Paper, May 2014).

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worth the time and expense to underwrite a loan for under $1 million, which is what many small businesses need to grow and succeed.

3. **Evolution of Risk Analytics.** A profusion of data and more advanced analytical tools enable digitally-native lenders to make better risk assessment decisions faster, while still complying with federal and state lending rules that govern credit decisioning (*e.g.*, the Equal Credit Opportunity Act). These data-driven approaches not only allow such lenders to extend credit to previously underserved communities of borrowers, but they also provide a much better borrower experience across the board (given the ability to turn around credit decisions in days or weeks instead of months).
4. **Investor Appetite for Direct Investment Opportunities.** A diverse group of investors are interested in stronger-yielding products, and are comfortable investing directly through marketplace platforms. Rather than investing in complex securitizations, many investors are willing to lend directly and build their own diversified investment pools.

The first and second factors above have contributed to a situation where demand for small business credit meaningfully outstrips supply. By one measure, small business lending (indexed to US GDP) has declined by 3-5% per year since the financial crisis, even as an ever-increasing share of small business owners seek credit and express optimism around how they could profitability drive growth in their businesses if given access to the capital they need.

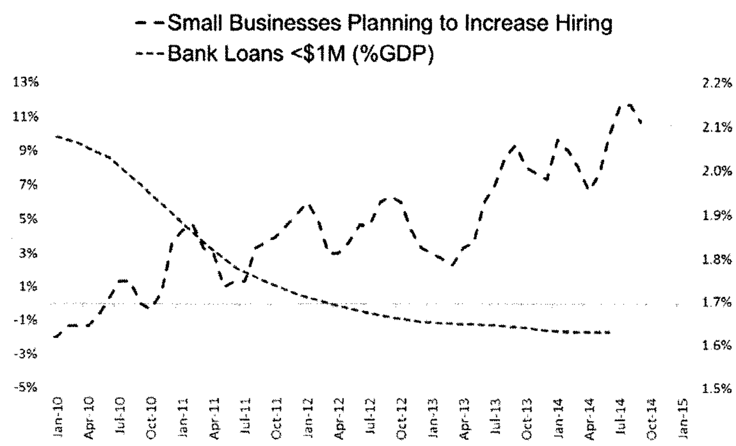

Exhibit 2: Small Business Growth Potential vs. Bank Lending[3]

[3] Funding Circle based this analysis on source data from the National Federation of Independent Business and the Federal Deposit Insurance Corporation.

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To help fill this gap, marketplace lenders like Funding Circle developed data-driven online investment platforms where a mix of different investors can put money to work in small businesses. This year we anticipate lending over $1 billion to great small businesses across the US and the UK, and we think that this model is still early-on in its vast potential.

Marketplace Lenders vs. Short-term High-rate Credit Providers

Without access to bank loans, or bank replacement-type products such as the fully-amortizing term loans that Funding Circle provides, small businesses seeking debt capital commonly enter into costly and burdensome short-term credit arrangements. For example, a small business may take a cash advance in exchange for allowing a credit provider to deduct a portion of its credit or debit card sales each day until the entire amount of the advance is repaid in what is generally called a "merchant cash advance." Or, a small business might borrow against projected future cash flow by taking a short-term "cash flow loan" requiring automatic daily repayments. While appropriate in certain circumstances – funding inventory purchases, or as a source of emergency funding, for example – such credit products oftentimes lead small businesses to use a short-term financing arrangement to cover longer-term funding needs. Moreover, in the current environment, a large share of small businesses qualify for short-term, high-rate loans while lacking access to more affordable long-term financing alternatives. These largely unregulated lenders typically charge small businesses extremely high interest rates and higher fees – oftentimes in the 50-100% APR range – to compensate for their much less rigorous underwriting processes. These two attributes – short durations and very high effective rates – drive many small businesses who use such credit products into downward cycles of re-borrowing in which they take out more and more debt to roll over their repayment obligations. At Funding Circle we see the damage these arrangements can inflict on small businesses – otherwise healthy companies are throttled by overwhelming and unexpected debt service requirements.

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Let me now turn to your work and what we see as some important opportunities for Congress to help small businesses access the capital they need to create jobs, grow, and contribute to your communities: First, we would recommend a few modifications to the JOBS Act that would further accelerate the formation of capital online in support of small businesses.

The JOBS Act: A Potential Missed Opportunity in Capital Formation for Small Business

As an online marketplace for small business credit, Funding Circle is frequently asked: did the JOBS Act make our business possible? As much as I'd like to say that the Act has significantly assisted in the development of this market, the reality is that Funding Circle and other marketplace lenders work within the strictures of much older regulatory regimes that seek to protect borrowers and investors. For example, a complex web of federal and state commercial

lending laws govern our lending and servicing operations, while more traditional securities regulation, particularly the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act, govern our capital formation activities. If anything the JOBS Act seems to be a missed opportunity to reduce some of the regulatory burdens placed on businesses that are seeking to form capital online. Indeed, although many of the Act's changes have proven beneficial, the Act fell short of one of its major aspirations – to meaningfully accelerate the formation of capital – particularly loans – for main street small business in the United States. Put simply, the Act, read as a whole, does not provide a viable approach for debt crowdfunding – *e.g.*, an avenue for helping small businesses secure loans online and so, despite all of the hard work that Members of Congress did across the aisle to pass the JOBS Act, main street is not seeing all of the benefits that Congress intended.

Unlike a venture-backed start-up, most small businesses are and should rightly be financed with loans, not equity; oftentimes, small businesses never "exit" and instead generate economic value through steady cash flows, which accrue to a small business owner and her employees. With sub-$1 million small business lending at its current low, small businesses need a better way of raising the funds they need to grow and expand now more than ever – and unfortunately the JOBS Act offers no such provisions. As such, we view the JOBS Act as a missed opportunity to help small businesses raise capital.

Three Proposed Refinements to the JOBS Act

The authors of the JOBS Act intended to modernize financial regulations to allow for businesses to raise capital from the public while ensuring investors and the public are adequately protected. The Act, however, has failed to provide an effective means for businesses to raise debt capital, *i.e.* through traditional debt markets, peer-to-peer models, or "debt crowdfunding." [4] Specifically, three core provisions of the Act hinder its suitability for the small businesses seeking loans to issue debt, namely:

1. **Limitations on funding portals from providing "recommendations" or otherwise curating investment opportunities.** To appropriately gauge the risk and return characteristics of debt securities (which generally have more limited upside than equity securities and whose returns are driven by the creditworthiness of an issuer), investors generally rely on third-party ratings and/or independent verification of an issuer's creditworthiness. The Act, however, specifically prohibits funding portals from providing assessments of issuers – even through provisioning of third-party scores and/or ratings – or otherwise curating investment opportunities.
2. **Onerous disclosure requirements for debt issuers.** The Act does not distinguish between appropriate levels of disclosure for issuing debt as opposed to equity. Although a certain level of disclosure is critical for either type of investment opportunity, the

[4] "Crowdfunding," broadly defined here, includes peer-to-peer platforms seeking to match investors with persons or entities seeking debt or equity financing.

specific prescribed disclosure requirements should better correlate to the relative risks of a particular type of security and issuer. For example, senior debt carries less risk than common stock offered by the same issuer, and thus should merit different disclosure standards. As written, the Act calls for a level of disclosure that makes debt crowdfunding disproportionately costly to an issuer.

3. **Strict limitations on the business models of debt crowdfunding portals.** An important intended benefit of the Act for issuers is limited preemption of state securities laws. In order to maintain this preemption, however, no associated parties may receive compensation for helping an issuer (the small business) raise capital either through a funding portal or other means. In equity crowdfunding, funding portals can receive compensation based on the performance of the issuers' equity securities – *e.g.*, carried interest on equity investments. In debt crowdfunding, where returns come in the form of regular interest payments, any split of interest fees or up-front commissions (whether paid by the borrower in the form of an origination fee, or paid by the investor in the form of an investment commission) would likely cause the issuer and the portal to lose preemption from state securities laws, meaningfully limiting the ability to form capital from a wide base of investors.

For these and other reasons, the JOBS Act does not provide small businesses an appropriate new method for forming debt capital. We detail each of these below – amendments to these sections of the Act should dramatically reduce the legal cost and barriers to debt crowdfunding, while still maintaining a robust investor protection regime.

Limitations on Providing Advice and/or Curating Opportunities

The Act exempts funding portals from broker-dealer registration, but rules proposed by the Financial Industry Regulatory Authority, Inc. ("FINRA") and the Securities and Exchange Commission (the "SEC") nevertheless impose significant restrictions on funding portals. Specifically, the Act authorized the SEC to unconditionally or conditionally exempt funding portals from the burdensome broker-dealer specific regulations so long as some authority, whether a self-regulated organization, such as FINRA, or the SEC, regulates the funding portal. Among other restrictions imposed, a funding portal may not offer investment recommendations or advice (discussed below), participate in solicitation of purchasers or sellers to buy or sell securities displayed on the portal, or deny issuers access to the portal absent suspicion of fraud (meaning that portals cannot curate investment opportunities).

Funding Circle believes the Act should be amended to lessen certain restrictions on funding portals that inhibit the efficient formation of capital and offer little, if any, investor protection. Among other changes, the Act should be modified to allow portals to provide information on credit (loan) investments hosted on a portal. Disclosure to potential investors of independently verified data and data generated by trusted and regulated third parties (such as credit rating agencies) regarding investments on funding portals increases transparency for investors. This disclosure would better protect investors and promote efficient capital formation by providing

sufficient data for investors to discern between creditworthy issuers and riskier issuers. The early experience of investors on Prosper, one of the earliest peer-to-peer lenders, supports this view. Prosper started with an open, unfiltered marketplace and, in those early days, Prosper investors directly evaluated loan opportunities and bid on them based on their investment preferences. This auction format allowed investors to artificially bid down interest rates on loans. Even though Prosper offered a product well-positioned for high returns, its average investor from 2005 to early 2009 lost 4.95% per year.[5] If Prosper had included additional disclosures to investors from the outset, perhaps it would have attracted those investors who truly had the appetite for the risk offered.

Under current securities laws, disclosing information useful for evaluating a loan investment, even if provided by a trusted third party, would trigger various regulations, including broker-dealer registration requirements. The specter of these additional legal obligations potentially harms, rather than protects, investors by dissuading portals from disclosing this useful information. Some of these restrictions may make sense in the context of equity crowdfunding, but they make little sense in the context of debt crowdfunding, when investors will rightly seek verification of a borrower's creditworthiness, and where an abundance of standardized metrics already exist for investors to effectively evaluate risk.

Overly-Onerous Disclosure Requirements for Issuers of Debt Securities

The Act set out to update securities laws to ease the regulatory burden on capital formation – to better serve issuers of all sizes and reduce the barriers for non-wealthy investors to access markets. To that end, the Act's disclosure requirements (to be promulgated by the SEC and FINRA) should not exceed what is necessary to protect investors. Extensive disclosures raise the cost of crowdfunding, which cuts against the spirit and purpose of the Act and provides few extra protections to investors.

Funding Circle suggests determining the appropriate level of disclosure for an offering on a risk basis.[6] The Act should calibrate disclosure requirements based on the type of investor and security. Although "sunlight is said to be the best of disinfectants" and provides the best investor protection, the Act does not sufficiently balance absolute disclosure with the transactional and operational cost associated with disclosure. For instance, the disclosure requirements in the Act do not sufficiently distinguish between accredited investors and non-accredited investors. Moreover, the Act does not distinguish between equity and debt securities. Debt securities, which have priority claim over equity securities in insolvency proceedings, might merit a lower disclosure standard, because debt securities typically entail less risk than equity securities.

[5] For more information on Prosper's early investor return data, *see* https://www.prosper.com/invest/performance.aspx.

[6] The Act tiers disclosure requirements based on target offering amount but does not fully adopt a risk-based disclosure relating to the type of security and investor.

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Limitations on "Portals'" Business Models

Another chief benefit of the JOBS Act is notionally to provide issuers with limited preemption from state securities laws. Under the Act, state registration is not required if an issuer conducts an unregistered offering under Rule 506 of Regulation D under the Securities Act ("Rule 506") so long as any person (*e.g.*, a portal) associated with the issuer is not compensated in connection with the sale of the securities. The SEC, however, will likely view debt originators' origination fees for loans to borrowers through crowdfunding as "compensation." Debt originators in the peer-to-peer space often earn revenue through origination fees and, as a result, do not likely qualify for state securities law preemption afforded by the Act. This potential exposure to state securities laws significantly limits peer-to-peer debt origination, especially in light of state-specific lending restrictions and the multifarious risks of regulatory sanctions (across any states where a portal works with investors).

In the context of the Act, Funding Circle suggests either narrowing the definition of compensation as codified in Section 4(b) of the Securities Act and interpreted by the SEC or extending state securities law preemption to Rule 506 offerings even where limited forms of compensation are involved. The latter suggestion holds greater appeal because it limits any unintended consequences that may accompany redefining "compensation" – a definition found throughout federal securities regulation. Absent state securities law preemption, securities offerings will vary by state, thereby promoting greater fragmentation and inefficiency in forming capital for promising businesses.

The main service and value added by crowdfunded lending marketplaces is their ability to match lenders to borrowers. The secret sauce of each company in the ecosystem comes from not only the innovative or otherwise proprietary underwriting process of the loan, but also the company's ability to source creditworthy borrowers. For this service, the company's business model typically relies on an origination fee (paid as a percent of capital raised for a borrower).

Funding Circle believes in full transparency to both borrowers and investors: the only fees we charge are an origination fee to the borrower to compensate for the underwriting process as well as the matching of investors, and a servicing fee paid by investors to cover the costs of servicing a loan. As mentioned above, under the JOBS Act, any origination fee would likely constitute "compensation" in a securities sale and, therefore, would render debt originators subject to state securities laws. If compelled to choose between charging origination fees and the regulatory burden associated with state securities law compliance, companies may be incentivized to generate revenue through less transparent means.

We offer these suggestions as a mechanism for better facilitating debt crowdfunding – our suggestions in this testimony are neither exhaustive nor comprehensive. Instead, we hope to shine a light on ways to consider amending the JOBS Act to strike a better balance between functional viability and investor protection – and to do so in such a way as to reduce significant legal and compliance costs associated with crowdfunding as practically stipulated under the Act. Through its requirements, the Act should guide portals seeking to help small businesses form

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capital from investors to do so in a manner that is both sustainable and adequately protects investors – but these requirements must achieve this objective without undermining the very impetus for change that gave rise to the Act. We hope that working together with lawmakers and regulators, we can help find a better path for the millions of small businesses who so desperately need access to capital. Anything less will be a significant missed opportunity.

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Before closing, I next direct the Committee's attention to why Funding Circle and certain other marketplace lenders who offer term credit differ substantially from other alternative credit providers that have otherwise been filling the small business lending gap, and how we as an industry are organizing around more sustainable lending practices.

Self-regulation in the Small Business Lending Market

Funding Circle is not alone in our growing concerns about the impact that the gap in access to small business credit is having in our country. In particular, this gap has allowed a category of high-rate and non-transparent lenders to seep into the market. In response to this trend, we are committed to working with other marketplace lenders, other responsible credit providers such as CDFIs and small business advocacy groups to architect certain industry standards that we hope will eliminate, or at least, discourage some of the more abusive practices that riddle the small business lending market.

While we expect those industry standards to cover a broad spectrum of issues and practices encompassed by responsible lending, lack of transparent pricing (including hidden fees, prepayment penalties, etc.) stand out as a particularly illustrative example of how Funding Circle continues to differentiate from many other lenders. We prominently disclose total and periodic costs of the loans we offer in an easy-to-understand and timely manner. This disclosure includes annualized interest rate, our origination fee and both the monthly and total repayment amounts. As a result, a small business owner can evaluate the true cost of credit and make an informed borrowing decision. In contrast to these relatively simple transparency measures, merchant cash advance and cash flow loan providers oftentimes quote financing costs as a factor rate or buy rate and rarely, if ever, provide an equivalent annualized interest rate -- even if asked. In addition, they often charge hidden or otherwise opaque fees, which are added to the cost of financing. Finally, such lenders often use fixed repayment schedules, where the same full repayment amount is due regardless of when the small business actually repays the advance or loan. In these cases, a credit provider may advertise "no prepayment penalty" even in a credit arrangement where prepayment would not reduce the total amount charged to the borrower.

As banks have continued to shift away from small business lending, American small businesses without adequate non-bank financing options remain vulnerable to the confusing, misleading, or, even worse, predatory lending practices common among short-term, high-rate lenders. In need of capital, small business owners will continue to enter into these short-term credit arrangements

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with payments that they cannot afford or onerous terms which do not allow them to operate effectively let alone grow. If this issue sounds familiar, that's because it is: consumers historically faced similar issues in payday lending and regulators rightly linked high rates of default and re-borrowing in payday lending to consumer debt traps. Similarly, in small business credit, short-term loans with very high interest rates, especially where credit providers collect payments through access to the small businesses' sales or deposit account, are much more likely to result in debt traps. At Funding Circle, we align our success with the profitability and success of the small businesses to which we lend. We extend credit to businesses only where we have a high expectation of repayment. Our technology-enabled credit processes balance speed with rigor. Being data-driven and using credit algorithms does not require jettisoning all traditional indications of creditworthiness such as a debt service coverage ratios, asset coverage ratios, or credit history. Our online application and advanced analytics deliver an efficient borrower experience while still pricing risk appropriately, so that we do not have to rely on excessive interest rates or high fees to offset poor performance across our loan book. Instead, the very transparency and simplicity of our product helps ensure that only borrowers who should be able to repay take out one of our loans.

As mentioned above, Funding Circle is committed to collaborating with other marketplace lenders, responsible credit providers and small business advocates to promulgate certain industry standards in small business financing in the US. In the UK, Funding Circle worked closely with other industry leaders, Zopa and RateSetter, to launch the *Peer-to-Peer Finance Association* as a self-regulatory body for the sector to promote high standards of conduct and consumer protection.[7] Along with other Association members, we worked closely with the Financial Conduct Authority to enact balanced legislation in the UK that would protect both investors and borrowers while also catalyzing important future growth in the industry.

Supporting marketplace lending represents a critical opportunity for policymakers to participate in paving the way for innovation to improve small business owners' access to affordable credit. But that support requires that policymakers truly listen to small business owners and understand their capital access needs. Marketplace lenders, such as Funding Circle, have already demonstrated an ongoing commitment to connecting supply – investor capital – and demand – term credit for small businesses – in a highly ethical, transparent and sustainable way.

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Conclusion

Thank you for the opportunity to present this assessment for the Committee's review. At Funding Circle, we are striving to build a better financial world by building a transparent, market-driven approach that delivers much-needed capital to great American small businesses while at the same time allows investors to earn strong risk-adjusted yields. We hope that these ideas provide a framework for considering how to further refine existing laws and policy

[7] For additional information on the Peer-to-Peer Finance Association in the UK, *see* http://p2pfa.info/.

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measures so that there is an even playing field between marketplace lenders such as Funding Circle and older-line lenders who are unable to deliver capital to small businesses who use it to expand and grow. This exciting segment of the market has already taken great strides in the past decade, and we anticipate even great growth in the years to come: our strong belief is that this will be beneficial for small business, for investors, and for our country as a whole.

Testimony of

Zachary L. Green

CEO and Founder

MN8 Foxfire

The Committee on Small Business

United States House of Representatives

Full Committee Hearing

May 13th, 2015

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Good morning. My name is Zachary Green and I'm the CEO and founder of MN8 Foxfire. I would like to personally thank Chairman Chabot and the members of the Small Business Committee for inviting me here today.

As a young man growing up in Cincinnati, Ohio, I had three distinct dreams:

1. To be a US Marine,
2. To be a firefighter, and
3. To be an entrepreneur.

Dedication, honor, teamwork, and most of all mission accomplishment were some of the life long values I garnered from my time in the Corps. I recognize that having the opportunity to pursue the American Dream is because of those that have gone before us. We must never forget that we are the land of the free ONLY because of the brave.

Several years later (and about 50 additional pounds), I fulfilled my second dream of becoming a volunteer firefighter, a rich American tradition started by one of our founding fathers, Benjamin Franklin. Being a firefighter, much like being a US Marine, taught me that no obstacle is too large, no hill is too steep and all challenges can be solved through leadership, teamwork and perseverance. After all, in the fire service we have to solve the problem at hand; we don't have the option of calling 912 after the homeowner calls 911.

The summers in Parris Island and Twentynine Palms were unbearable. Marine Corps Officer training in Quantico, VA was extremely challenging, as is being a firefighter running into a burning building while everyone else is running out.

But all of these pale in comparison to the challenges I have encountered fulfilling my third dream: becoming an entrepreneur.

I came up with the idea of MN8 Foxfire while sitting on the tailboard of my fire engine. As a firefighter, some of our biggest risks are accountability and disorientation, all of which are compounded exponentially in the dark. I remembered seeing a special about September 11th and how the 9/11 commission report noted several times how photoluminescence materials helped people evacuate the twin towers before they collapsed. I thought of ways in which I could apply this same technology to firefighter accessories. During the next several months, I drove from fire station to fire station selling MN8 Foxfire accessories out of the trunk of my car. Sales steadily increased, and my former Fire Chief, Robert Rielage, sat me down and told me how much he believed in me and this product. He said I shouldn't just treat this as a hobby, but rather look at how to really grow the company. As I walked out of his office, I remembered the words of one of my favorite leaders, Theodore Roosevelt: "In any moment of decision, the best thing you can do is the right thing, the next best thing is the wrong thing, and the worst thing you can do is nothing."

I refinanced my home, maxed out my credit cards, and took nearly all of my family's savings to officially start my journey to entrepreneurship. I'm proud to say that we now have more than 60,000 firefighters using Foxfire products. Additionally, we have grown our safety line of products such as eco-friendly EXIT signs (that never need maintenance, batteries or electricity), and a patented product that goes on stair edges that today illuminate the stairwells of sports arenas, high-rises, and universities all over the US and abroad. Thanks to the help of the US Dept. of Commerce's Commercial Services division, we have also exported this technology to more than 25 countries throughout the world, including the Civil Defense headquarters of the United Arab Emirates.

In 2013, MN8 Foxfire was awarded the "Excellence in Entrepreneurship" award; and I was named "Entrepreneur of the Year" by the Ohio Chamber of Commerce. I could not have been more proud, but every day is a struggle.

One of Foxfire's biggest challenges—one many small business owners share—is the access to working capital. I love my mother very much, but the words of one of my mentors could not ring more true: Cash Is More Important Than Your Mother. I always thought the more Foxfire grew and the more we sold, the less I would have to worry about capital. I could not have been more wrong. When I realized that my personal investments would not be enough to finance our rapid growth, I raised capital from friends and family. With that capital, I hired more staff and bought more inventory, but it was still not enough to keep up with our supply chain and overhead costs. I next worked with a local venture capital advisory firm and raised additional funds. Those funds coupled with lines of credits from our regional lender, Bank of Kentucky allowed us to continue to grow.

Almost every entrepreneur I know has the same reoccurring nightmare: running out of money. Several months ago, due to several unforeseen circumstances, this almost happened. We were fortunate to find a new stream of access to capital online through StreetShares, a peer-to-peer lender described by the press as "Shark Tank meets eBay". We presented our business case with historical financials, tax returns, and a pitch describing how we would use the new funds.

StreetShares is a peer to peer internet-based marketplace that matches borrowers and lenders by shared social affinity—such as in this case, veterans lending to veterans—to drive down the rates and risks of a loan through a reverse auction model. Our loan was funded from a pool of investors who competed to take a portion of our loan, each setting their own rate of return. These investors reviewed Foxfire's pitch and bid to fund a part of our loan. StreetShares combined all the lowest bids into a single loan for us. They bid down our rate because they knew we were a veteran-owned business, and many of the investors were veterans themselves. In under 36 hours, Foxfire received the money we needed. The interest rate was in the teens.

If we had gone through this same process with a traditional financial institution, it would have taken months. If we had gone to

one of the many small business "payday" type lenders online, they would have charged us an outrageous APR. The StreetShares loan had a reasonable APR, but was just as fast. If it were not for the quick access to an online peer-to-peer loan, I fear the worst could have happened. This is the perfect example of how the free market can act faster than larger, traditional institutions, and keep the American Dream alive.

I became a US Marine, a firefighter, and thanks to new ways to fund startups like peer to peer micro loans, I am on my way to becoming a successful entrepreneur.

Thank you again for your time today.

Testimony of

Peter Renton

Founder & CEO

Lend Academy

before the

Committee on Small Business

United States House of Representatives

May 13th, 2015

My name is Peter Renton and I help run three businesses that are all focused on the peer to peer (P2P) lending industry. I am the founder and CEO of Lend Academy, which operates the leading P2P lending blog, podcast and community forum. I am the co-founder and CEO of the LendIt Conference, the first and largest conference series dedicated to the broader online lending industry. I am also a co-founder of NSR Invest, which is an investment and analytics platform that provides access to P2P marketplaces for financial advisors, institutional investors, and individuals.

As you can tell, I was not born in this country. I grew up in Sydney, Australia where my father was an entrepreneur and I joined the family printing business one year after graduating college. Like most entrepreneurs in Australia I dreamed of one day starting a business in this country and I was able to do that in 1991 when I moved to Denver, Colorado to expand our family printing business. Since then I have started several other businesses ad in 2003 I proudly became a United States citizen.

I have been investing in P2P lending platforms (now often referred to as marketplace lending platforms) since 2009 and I have been covering this industry full time as a blogger and analyst since 2010. What I would like to do in this testimony is give you all a little history and overview of the P2P lending industry, particularly as it pertains to small business.

Short History of P2P Lending

In this country P2P lending began in 2006 with the launch of Prosper, industry leader Lending Club followed just a year later. The SEC decided in 2008 that the loans issued by these companies are securities and should be registered with the SEC. So both companies went through a long and expensive registration process to remain open to non-accredited investors and comply with this decision. To this day these companies are the only peer-to-peer lending platforms to have undertaken this registration process. While there are dozens of platforms today every other company is only open to accredited or institutional investors.

It should be noted that Lending Club and Prosper are primarily consumer-lending platforms but they have been doing quasi-small business loans since inception. Many small business owners use their personal credit to fund their businesses; I have done that myself in the past. Since inception Lending Club and Prosper have originated around $200 million in personal loans that were used for business purposes.

In addition to these personal business loans Lending Club has had their own small business lending program for over a year offering term loans of between 1 and 5 years. Lending Club does not share their loan volume here but my understanding is that this initiative is still relatively small although it is growing quickly. Prosper has a referral program with OnDeck Capital the largest online small business lender.

Brief Explanation of Products Offered

I should explain the variety of products offered by the broader online lending industry:

1. Term loans - typically 1-5 year amortizing loans with relatively low interest rates.

2. Lines of credit - to be drawn against as the need arises, has a wide range of interest rates.

3. Merchant Cash Advance - high interest, short term advances with repayments tied to credit card receipts.

4. Invoice Finance - also known as factoring where small business can get immediate cash for their receivables.

5. Crowdfunding - is not lending at all. Can be an equity based investment or a rewards-based "donation".

What Can Government Do?

I appreciate the fact that you are having this hearing and that you are interested in learning more about this industry. The continued growth of this industry will provide many benefits to small business owners and the economy as a whole.

As to what government can do here I would like to describe some of the actions the UK government has done. They provide a blueprint for supportive actions that a government can take to impact this industry.

1. Since 2012 the British Business Bank, wholly owned by the UK government, has been investing in small business loans issued by online platforms like Funding Circle. While the total investment is relatively small this action has given the industry there a tremendous boost in credibility and trust among investors and borrowers.

2. They have created a new regulatory framework specifically for the P2P lending industry.

3. Last year the UK government announced the creation of a bank "mandatory referral scheme" where banks that reject small businesses for a loan will have to refer these businesses to alternative lenders.

Now, I am not saying that the US government should copy these actions but rather they provide some ideas of how governments can support this burgeoning sector.

I firmly believe that small business lending is going through a transformation that will have a dramatic impact on the growth of small business in this country. I hope and trust that you will see the benefits we bring and will be supportive of this transformation.

ELECTRONIC TRANSACTIONS ASSOCIATION

Electronic Transactions Association

Statement for the Record

May 13, 2015

House Committee on Small Business

The Electronic Transactions Association (ETA) applauds the Committee for its hearing on "Bridging the Small Business Capital Gap: Peer-to-Peer Lending."

ETA represents over 500 companies from around the world, many of which are small businesses. Small business are the backbone of our economy and jobs. ETA member companies are vital to the success of small business by facilitating not only the payment needs of existing merchants, but in bringing new businesses into the payments system. Additionally, many of ETA's small business members are helping to develop new technology to make payments more flexible, faster, and safer.

ETA believes that small businesses should have multiple financing options available to them, which is why we commend Chairman Chabot and Ranking Member Velazquez for holding this hearing on the important topic of peer-to-peer (or "marketplace") lending for small businesses.

Marketplace lending is serving an important need, particularly as traditional lenders and regulators have tightened available credit for small businesses. These new, technology-enabled lenders have stepped in to fill the need for small business in all 50 states. And while traditional financial institutions provide valuable service to millions of businesses, marketplace lending increases available options for small businesses.

A recent industry report[1] calculated that the first $1 billion lent by one of the largest marketplace small business lenders generated 22,00 jobs and boosted the U.S. economic activity by $3.42 billion.

In addition to filling the funding needs for small businesses, many marketplace lenders, have utilized technology to develop more accurate underwriting tools thereby reducing the time it takes to move from application to approval to disbursement of funds to the small business. And, as you know, for small businesses, time is critical, the ability to deliver funding quickly, means opportunities will not be missed. The same study indicates that one of the main reasons half of all businesses did not apply for financing from a traditional bank is that the process would take too long.

ETA applauds the House Committee on Small Business for holding the hearing on this important topic, and we look forward to working with Committee members to strengthen the marketplace lending market to allow small businesses access to the financing they need.

The Electronic Transactions Association (ETA) is the global trade association representing more than 500 payments and technology companies. ETA members make commerce possible by processing more than $5 trillion in purchases in the U.S. and deploying payments innovations to merchants and consumers.

For more information go to: www.electran.org

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[1] OnDeck, How Delivering Our First $1 Billion to Small Businesses Has Helped Drive the US Economy, *Analysis Group* (May 2014).